

ON FISCAL FEDERALISM: ISSUES TO WORRY ABOUT

By
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Introduction

A couple decades ago fiscal federalism used to be a topic of marginal importance in most countries and in the economic literature. The world was broadly divided in federal states and unitary states and there were hardly any countries that planned to move from one to the other of these categories. In recent years, however, perhaps as a result of globalization and deepening democratization, combined with rising incomes, centrifugal forces seem to have been put into action in many countries. These forces have generated growing demands for increasing degrees of fiscal decentralization. It can be hypothesized that decentralization is a superior good, the demand for which is likely to grow with per capita income.

This paper discusses informally some issues that seem to be highly relevant to the decision to decentralize or not or to the likelihood that decentralization would produce useful results. It argues that decentralization is more likely to be successful if some conditions are met **before** the process of decentralization starts. Some would argue that once decentralization occurs, the subnational governments will respond to the challenge by improving enough and quickly to make the process successful. But this may be wishful thinking. Below I will address some of the relevant issues.

I. Decentralization and the Size of Countries

One of the strong theoretical arguments advanced in favor of fiscal decentralization is that the preferences and the needs of citizens and taxpayers for public sector activities are better known to the local government officials than to those who represent the central government. The reason given is that contiguity provides more information while distance reduces the amount of information necessary to make good decisions. This argument is assumed to be strong enough to neutralize the advantages that economies of scale in the production of public goods and public services and in the generation of tax revenue may give to arrangements that keeps more power in the hands of central government.

If accepted, the above argument implies that small countries should be more successful than large countries in satisfying the social needs of their populations. Thus, if the arguments for decentralization were valid, there would be strong reasons for breaking up countries and weaker reasons for fiscal decentralization.

II. Decentralization and Privatization

When decisions are being made on whether to proceed with fiscal decentralization, it is customary to start with the existing functions of the central government and to identify those that could be transferred to subnational governments. It is generally ignored that many governmental activities can be either transferred to the subnational governments (through fiscal decentralization) or, alternatively, they can be transferred to the private sector. Thus, it would be useful to consider privatization as a possible alternative to decentralization for at least some of the governmental activities. It can be hypothesized that the smaller is the role of

government in a country, the less need there is for decentralization. A minimalist government would probably be best if it were largely a national government. Thus, the need for decentralization may grow with the size of the government.

What kind of activities lend themselves to privatization and what kind lend themselves to decentralization? This is an important question which, to my knowledge, has not been addressed directly in the relevant literature. With the experience of recent years, it appears that many of the things that governments have done can be done equally well, or better, by the private sector. Technological developments are helping in this direction. Recent experiences from many countries show that the privatization of many public activities is not only feasible but also desirable. Examples go from collecting garbage, to providing electricity, transportation, water, health services, education and even all or part of pensions. Even jails or cemeteries can be privatized. Some of these are exactly the activities that are often in discussion for decentralization. Thus, privatization should be considered as an alternative to decentralization for many public activities. Of course, privatization is not always the best option, but it should always be an option to consider.

The more extensive is the process of privatization, the lesser justification there must be for fiscal decentralization. It would be interesting to make a careful inventory of activities that can be either privatized or decentralized and to assess the potential costs and benefits of these alternatives. As already said, in many instances, if an activity can be decentralized, it can also be privatized. The above argument must recognize that the citizens of a country might wish to keep an activity public even when the private alternative is available. This is, for example, the case with some cultural activities.

III. Decentralization and Regulations

Subnational authorities, including municipalities create many regulations. In fact, it is my observation that in many countries, a large proportion of regulations, and especially of regulations affecting economic activities, are not imposed by national but by subnational governments. Each level of government feels the need to spend money and to regulate some activities.

We could hypothesize that the more decentralized the government becomes, and the more layers of jurisdictions come into existence, the more regulations will be introduced. Some of these regulations will be necessary and useful; many will be much less so or even damaging. The reason is that each administrative layer will want to pursue its own objectives and often it will not have the financial means to do it through spending. It will, thus, rely on regulations. Thus, each time one adds another layer of government—be this provincial or regional government—the number of damaging regulations is likely to increase.

I have not seen any research on the relationship between the degree of decentralization and the number of regulations in a country. Such research would indicate what happens when a country adds additional governmental levels. What happens if each level pursues its own objectives, not just through taxes and public spending, but also through regulations? Direct observation suggests that the more constrained are the authorities of countries in raising revenue and in spending, the more likely it is that they will try to rely on regulations to pursue their objectives. For obvious reasons local governments are often much more constrained in raising revenue than national governments.

IV. Decentralization and the Internal Market

It is generally taken for granted that a country represents a single market within which labor, capital, or goods move more freely. However, in decentralized countries and especially those with less respect for markets, each jurisdiction may introduce rules that lead to some *de facto* fragmentation of the national market. Residency or other requirements may restrict the movement of labor; and various transparent or hidden obstacles may restrict the movement of goods and capital.¹ It has been reported that, in some countries goods cannot always be moved from one region to another without going through domestic "frontiers" and *de facto* "customs".

There are various impediments to market activities that originate either from regulations or from taxation. Think of tax competition within the United States or Brazil. Tax competition among states or regions, through different incentives for enterprises, contributes to some misallocation of capital. And different sales taxes or personal income taxes may have influenced spending patterns and the allocation of labor.

It would be useful to study the effects of different regulations and taxes on the domestic markets of countries such as Argentina, Brazil, India, Russia, and China. This research is likely to conclude that these effects may be significantly negative for resource allocation and for growth. On the other hand, a unified country—that is a country that is not fiscally decentralized—generally does not have these problems or at least, it will not have them to the same extent. In these countries, however, there may be intentional attempts at interfering with market decisions by, for example, providing incentives for investment in

poorer areas. In conclusion, in many practical situations decentralization may be market constraining rather than market enhancing.

V. Decentralization and Corruption

Another issue of potential importance relates to governance and corruption. Some papers have called attention to the potential connection between decentralization and corruption. Others have attempted to refute the existence of such a connection or even to argue that decentralization reduces corruption. The reason for hypothesizing the existence of a relationship between decentralization and corruption is that, in many countries, local institutions are less developed than national ones. Many reasons account for this; for example, the brightest people tend to join the central government where their long run career prospects are better. Furthermore, the national governments are likely to be able to create more transparent and more accountable public administrations. For example, foreign technical assistance is generally directed towards the central government and not the local governments.

These considerations have to be qualified, of course. In countries such as Australia, Canada, Germany, and the United States the educational level of the population is so high that highly trained people are available for all levels of government and thus, good institutions can be created by all. However, in many countries the best and most talented people join the national government while the quality of the local government institutions tends to be lower. Lower salaries, less prospects for advancement, various regulations, and greater contiguity of employees and citizens, also increase the possibility that poorer

¹ For example, residency requirements may limit access to local subsidies and services or to particular jobs.

governance will be more common in local governments. Casual observations indicates that corruption is, in fact, more widespread at the local than at the national level. In the United States, for instance, cases of explicit corruption have been reported over the years in local governments but rarely in the national government. Recent empirical attempts at settling this question have so far given conflicting results.

VI. Decentralization and the Assignment of Taxes and Expenditures

The relationship between decentralization and the assignment of taxes and expenditure is an important feature of fiscal decentralization. Assigning expenditures means deciding what are the responsibilities of the national and of the sub-national governments. Like contracts, these decisions are never, and can never be, precise and final. In the United States for example, education is supposed to be a responsibility of the sub-national governments. However, the federal government intervenes often to define curricula and standards, to grant research money, to regulate, to allocate scholarships, and so forth. This problem is, of course, not limited to the United States. It often brings friction between the local representatives and the national government and obfuscates their distinctive responsibilities. The problem is that it is difficult to assign precise expenditure responsibilities. As a consequence, responsibilities often overlap. Thus, confusion arises when two or three different jurisdictional levels step in to pursue similar objectives. This confusion, of course, has implication for public spending because somehow the responsibilities of the subnational jurisdictions must be financed through taxes or transfers.

The assignment of taxes is difficult because administrative considerations, economies of scale in tax administrations, access to information, tax competition and other factors have to be taken into account. In this connection, I would like to mention the role of land and property taxes which are the taxes more easily assignable to local jurisdictions. Land and property taxes play an important role in countries where the local governments work relatively well. Such taxes generate about 3 percent of GDP in the United States, the United Kingdom and a few other countries. But the taxation of real property is not easy because it requires reliable and updated cadastral values or current market values for the taxed properties. In the United States, cadastral values are not needed because the sales of properties are more frequent and more transparent than elsewhere. Thus, the local tax administrations can rely on sales prices to determine tax liabilities for the sold properties and for similar ones. However, market valuation is much more difficult in countries where sales take place less frequently or where they are less transparent.

Various solutions have been attempted over the years by countries such as Colombia and others. An interesting suggestion was made four decades ago by Maurice Allais, the Nobel Price winner from France, in a book that, unfortunately, has not been published in English. Allais proposed that people self-assess the value of their properties. Their self assessments would be made public. Anybody who wanted to buy these properties at, say, a certain percentage **above** the declared price could step forward and propose to buy it. If the seller refused to sell, the bid plus a penalty would become the base for determining the property tax. At least, in theory, this is a relatively simple and self-enforcing mechanism that

could be tried. In some countries the government has the right to buy the property at the self assessed or declared value, but this right is rarely exercised.

Other taxes have been assigned to local governments. These range from retail sales taxes in the United States, value-added taxes in Brazil, turnover or cascade taxes in Argentina, IRAP taxes in Italy, income and excise taxes in many countries, and so on. In some taxes, such as Argentina and Russia the national government has shared some of the collected taxes with the local governments. In China, it was the local governments that shared their taxes with the national government.

In general the greater are the regional differences in per capita income and the more uniform are the standards of public services that the national government wants to provide, the greater must be the transfers from the national to the local governments. But transfers create moral hazards and at times situations where soft budgets become the norm.

VII. Decentralization and Tax Reform

The existence of a decentralized fiscal structure has often been a major impediment to needed tax reforms. Let me provide a few examples.

Brazil has been trying to reform its value-added tax for many years but it has faced great difficulties because the current value-added tax is levied at the state level. It has been impossible so far to reach a consensus among the state authorities for changes that would make the tax system more efficient. The current value-added tax encourages tax competition among the states and creates a substantial fragmentation of the domestic market.

Argentina continues to have an old-fashioned turnover tax—similar to those that existed in European countries in the 1950s before the value-added taxes were introduced. It is a cascading tax levied at the provincial level. For many years the central government has wanted to eliminate this tax which creates distortions in the economy (including the discouragement of exports) and to replace it with more efficient revenue sources. This issue has been in continuous discussion for many years between the national government and the provincial governments. Experts on both side agree that the present system is inefficient and needs to be changed. However, the tax generates substantial revenues and the federal structure has made it difficult the reaching of a consensus for reform. Because changes would affect different provinces differently, almost any proposal is opposed by some region.

India would be much better off having a value-added tax rather than the awkward arrangement it now has with many, distorting excise taxes. However, the central government cannot make the change because of the decentralized structure of the country. Once again almost any change is opposed by some state. These are not isolated examples but tell a rather common story.

In countries with revenue sharing arrangements between different levels of government, varying shares of the revenue from particular taxes go either to the national or to the local governments. These sharing arrangements affect both tax administration and tax policy. For example, in Argentina, in the 1980s, when the national government desperately needed more tax revenue, it paid more attention to taxes for which only a small share of the revenue went to the local governments. For these taxes much of the revenue increase remained with the national government. Some of these taxes were very inefficient taxes such

as those on export and import. However, because the national government got most of the revenue increase, at a time when these revenue were badly needed, these taxes were preferred. This process inevitably distorted the structure of the tax system.

In some cases, such as Russia, the tax administration may pay more attention to some taxes than to others when it responds to the political pressures coming from a particular level of government.

VIII. Decentralization and Macroeconomic Coordination

The potential conflict between decentralization and macro-economic policy has been occasionally mentioned in the literature. Richard Musgrave, for example, recognized this problem 40 years ago. With a decentralized fiscal structure it becomes more difficult to coordinate fiscal policy in a counter-cyclical sense. At times, subnational governments may pursue expansionary fiscal policy at the time when the national government is pursuing a contractionary policy. This is especially true when the local governments face soft budgets and can easily borrow. Local governments may incur large debts when they believe that the national government will bail them out. In past years these problems have loomed large in Argentina and Brazil and in some other countries. These problems become much less important, even within a decentralized structure when the responsibilities of the various governments are well defined.

IX. Decentralization and Transparency

Transparency is an area of increasing interest: the new architecture of the international financial system has given a great importance to this issue. It is more difficult to

achieve fiscal transparency when the sub-national jurisdictions are fiscally important and when they operate independently from the national government. Quite apart from the difficulties in understanding the nature of their operations, local governments rarely generate and provide good data on a timely basis. This of course, complicates the conduct of fiscal policy and the analysis of public sector operations as anyone who has tried to do comparative analysis of different countries knows well. For many federal countries it is almost impossible to have good data for the **general** government.

X. Decentralization and Regional Disparities

In a decentralized setting, and especially when ethnic differences characterize the population and these differences are characteristics of different parts of the country, the various regions of a country may begin to see themselves as different from the rest of the country thus putting in motion centrifugal forces. We have seen this in various countries. This problem tends to have serious implications for countries with important natural resources located in particular regions. In a centralized country, such as France if, for example, large oil deposits were found, it would not matter where in the country they were located. The government would be able to exploit or tax them and use the money to finance its **national** activities.

In highly decentralized countries, such as Nigeria, Indonesia, or Russia if natural resources are discovered **in one region**, problems often arise because that region will attempt to claim for its own use the revenue from the resources discovered. This leads to political problems and, occasionally, even to wars between regions. It also creates problems for the

income redistribution role of the government. One of the major functions of a national government is precisely to redistribute income from richer regions and individuals to poorer regions and individuals through the broadly uniform provision of public goods and services.

When the income levels of regions within a country are relatively equal, and when important natural resources are not concentrated in one region, it is easier to have a well-functioning decentralized system. However, when income levels are vastly different among regions, so that one region has to subsidize another on a significant scale, it becomes much more difficult to pursue an effective policy of income redistribution. When the difference in income is due to the concentration of natural resources in one region, in a decentralized environment the difficulty in pursuing such a policy can become particularly great.

XI. Decentralization and Public Sector Employment

One last point that I would like to make is that decentralization **may** generate larger public employment because of the need to have public administrations at more levels than in a centralized structure and because of the more limited ability to exploit economies of scale. This conjecture could be tested with actual data. I am not aware of any study that has attempted to test this assertion.

Conclusions

Given the issues that I have briefly reviewed, it should be obvious that I do not belong to the group of optimists who believe that fiscal decentralization is often the solution to many problems. I would rather conclude that, if decentralization is an important **political** objective for a particular country; if the country can establish the institutions that will make

decentralization work with a reasonable degree of efficiency—institutions related to tax policy, tax administration, expenditure management systems, budgets and so forth. Especially institutions that allow the central government to transfer resources to local government with some assurance that the resources will be used effectively and for the purpose for which they are passed on, then I believe that decentralization can be a good policy. However, under different circumstances—which unfortunately are more common than many economists recognize—I would be more reluctant to recommend to a country that is not already decentralized to start a decentralization process. If the country is already decentralized, and especially if the constitution of the country requires that it be so, then there is not much one can do except to live with it and try to make the process as efficient as possible. In such case, the effort should go into improving the institutions necessary for making fiscal decentralization work.

In a first-best world, there is one key decision to make: whether the government should be unified—as in the French model—or decentralized—as in the American model. If the territory is too large to be optimally administered by one government, assuming that there are no military or security threats, the option of having several smaller governments instead of one large decentralized government should probably also be considered. This is particularly the case when the population of the country is not homogeneous and the country does not have a long history as a single entity. It is easier to have an efficient government in a small open economy than in a large territory as the contrast between Singapore and, say, India shows.

In most real-world cases, we are dealing with countries that, to some extent, are already decentralized. Decisions are made at the margin and the main issue is whether to decentralize more. We must recognize the validity of the argument that the conditions for the success of decentralization could, in theory, be created by the process of devolution itself and that there are examples of local governments that are able to respond to the challenge of increased responsibilities. However, the experience gained in a large number of countries where the Fiscal Affairs Department of the International Monetary Fund has done work in this area suggests caution in this process because the conditions for successful decentralization are often not present. When this is the case, more decentralization means that the country pays a price in terms of efficiency and/or stability.

As I indicated at the beginning, these provocative remarks have the purpose of stimulating the discussion. We have at this conference some of the most knowledgeable people in the world on these issues. I am sure that some of those present will challenge my rather negative assessment of the wisdom of encouraging countries to become more decentralized especially when the needed conditions are not ready for such a policy. But, may be, some will share my views. Hopefully, we shall all benefit from a frank and enlightened discussion and will end the conference a bit wiser.